WILSONS

Wilsons' Guide to Australian Equities Income Investing

Our weekly view on Australian equities.

01 October 2020

The Challenges and Temptations

Income focused investing has proved to be a difficult investment style in Australian equities in recent years.

Only 10% of professionally managed income funds have outperformed the market over the last 5 years, in contrast to 70% of growth funds, according to Lonsec. This is partly a reflection of the market's strong preference for growth over value (a proxy for income) in recent years.

This challenge is made more significant if investors are index aware. Nearly half the market's income stream comes from just 6 stocks – the major banks, BHP and RIO. Two of those 6 companies cancelled their dividend altogether in the last 6 months, while the banks currently have regulatory caps on their dividends.

Investors should resist the temptation to select stocks solely based on high yield as they too often become dividend traps – AMP (AMP) and Telstra (TLS) being two recent examples where dividend cuts shortly followed what appeared to be high yields.

When looking for stocks for income, the combination of dividend growth, resilience (financial and business strength) and yield is important.

As equities are a growth-orientated asset class, history shows companies with the ability to grow dividend income streams are more likely to outperform on a total return basis than companies that are unable to grow their dividends.

This contrast can be seen in REA Group (REA) and Telstra's (TLS) total return profiles. Refinitiv data shows that REA has grown dividends by 9.5% compound annual growth rate (CAGR) over the last 5 years, providing a total return of 167%. TLS delivered -12% dividend CAGR, generating a -29% total return over the same time period.

When it comes to income investing here is what investors should not ignore.

Income Investors Should not Ignore Growth

The dividend discount model (DDM) for valuing equities provides the clue. It is not just growth investors, but also income investors that need to consider growth. For income investors, the growth of the dividend stream (a proxy for earnings growth) is too often overlooked.

Exhibit 1: DDM tells us both the dividend and growth rate are important

$$V_0 = \frac{D_1}{r - g}$$

Source: Wilsons

In our DDM example, we show that for two companies with the same dividend and discount rate but two different rates of dividend growth, the company with a higher growth rate will command a significantly higher share price.

Exhibit 2: The growth rate of dividends is important for company valuations

DPS (D1)	30
Discount Rate (r)	8%
Low growth rate (g)	3%
High growth rate (g)	5%
Implied Valuation	
Low Growth Company	$6.00
High Growth Company	$10.00

Source: Wilsons

The trend of rewarding stocks that have higher growth than traditional (lower growth) income stocks, with higher share prices, has been a particularly evident trend over the last 5 years in a low interest rate world.

Exhibit 3: In recent years, the market has rerated growth stocks more highly than income stocks

Source: Refinitiv, Wilsons.

Income Investors Should Not Ignore Dividends

While the growth of dividends is important, investors should not ignore dividends and focus solely on growth as it exposes investors to companies which are often more volatile (share price) in nature, particularly in Australia.

The Australian market is typically one of the highest income-producing markets globally, with around ~50% of total returns comprised of income over the last 50 years.

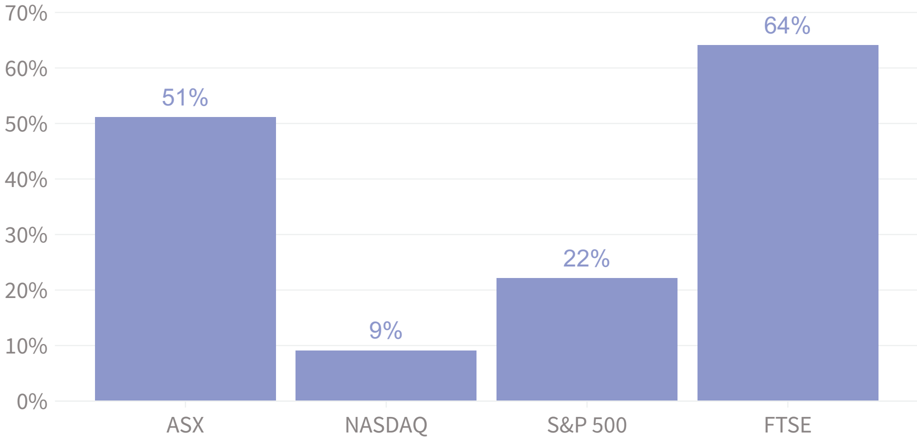
In contrast, the growth-orientated NASDAQ index has less than 10% of its total return from income. Typically, the Australian market has an income yield 3.5-5.5% compared to the NASDAQ, which typically yields around 1.0-1.5%.

The combination of both growth and income can be powerful. In Australia, it has delivered impressive returns over a long period. Credit Suisse's (Feb 2020) annual measure of best-performing equity markets over the last +100 years ranks Australia as the best performing equity market globally on a total return basis in both A$ and US$ terms.

Balancing Dividend Income and Income Growth

Income focused investing is more than just choosing a selection of the highest yielding stocks. Ultimately there is a balance to strike between the level of dividend income and the rate of income growth, and getting it right is the best way to ensure the joint goals of income and capital preservation can be met.

Exhibit 4: Australia has a high-income component as a proportion of total market return



Source: Refinitiv, Wilsons.

Wilsons' Preferred Income Basket

Our 15 stock basket aims to find a selection of S&P/ASX200 stocks which are likely to grow dividends over time, and potentially provide total shareholder return better than the market.

The stocks have been selected using a combination of three screens:

1. Growth (historical/forecast earnings and dividend)
2. Dividend yield (forecast yields, payout ratios)
3. Financial strength (ROE, financial leverage, interest coverage, commitment to dividends). We have overlaid our own views and ensured some mix of sector representation

The basket is not designed to be a static list but is representative of the stocks income investors should be considering at present.

Exhibit 5: Wilsons' preferred income basket

Ticker	Company Name	Industry	Yield (FY1)	DPSg CAGR (FY1-FY3)	EPSg CAGR (FY1-FY3)	ROE (FY3)	Interest Cover (NTM)	Franking
High normalised dividend growth								
SSM	Service Stream	Industrials	4.6%	10.8%	4.2%	17.2%	39.2	100
CWY	Cleanaway Waste Management	Industrials	2.0%	17.2%	15.3%	7.4%	13.3	100
TWE	Treasury Wine Estates	Consumer Staples	3.4%	18.2%	17.8%	11.9%	8.0	100
AZJ	Aurizon Holdings	Industrials	6.0%	8.3%	8.9%	14.4%	9.4	70
HMC	Home Consortium	Real Estate	4.4%	16.4%	23.9%	6.0%	5.0	100
Growth and yield								
WBC	Westpac Banking Corp	Financials	4.6%	92.5%	34.7%	8.5%	n/a	100
ANZ	Australia and New Zealand Banking Group	Financials	4.5%	41.5%	16.3%	8.1%	n/a	100
CCL	Coca-Cola Amatil	Consumer Staples	2.7%	32.5%	14.7%	23.9%	11.6	0
MQG	Macquarie Group	Financials	3.0%	31.4%	21.5%	13.4%	n/a	40
WPR	Waypoint REIT	Real Estate	5.4%	14.8%	16.7%	6.4%	16.7	0
Long term reliable yield plays								
TCL*	Transurban Group	Industrials	2.8%	23.3%	15.2%	9.4%	2.3	0
WES	Wesfarmers	Consumer Discretionary	3.4%	5.8%	6.1%	21.0%	21.7	100
APA	APA Group	Utilities	4.7%	4.4%	13.7%	17.7%	3.3	32
ALX*	Atlas Arteria Group	Industrials	2.4%	67.4%	21.3%	16.0%	0.9	0
AMC	Amcor PLC	Materials	4.4%	7.6%	4.2%	23.1%	10.3	0
Basket Simple Average			**3.9%**	**26.1%**	**15.2%**	**13.6%**		**56%**
S&P/ASX 100			**3.1%**	**6.3%**	**13.2%**	**11.0%**		**65%**

*TCL and ALX use EBITDA rather than EPS. Past performance is not an indication of future performance.

Source: Refinitiv, Wilsons.

We have grouped the basket into three sub-categories:

1. High dividend growth – stocks with high expected dividend growth over the next three years, primarily driven by growth in core earnings
2. Growth and yield – stocks offering a mix of dividend growth and yield. In some cases, the dividends have been impacted by COVID-19 and are expected to improve
3. Long-term reliable yield plays – stocks with strong market positions and a strong history of dividend friendly initiatives

The basket produces superior metrics to the market across yield, dividend growth and quality or return on equity (ROE).

Tax Advantages Should Not be Forgotten

Franking and tax-deferred income can provide a boost to after-tax income returns. The benefit of this tax advantage is highly dependent on individual investor factors, but can be as large as a +40% increase in dividend related income for a fully franked vs an unfranked dividend.

In recent years the franked proportion of income from the market has been declining from 70% in 2010, to 65% in 2020. This is largely a factor of Australian companies increasing their global exposure.

The slow erosion of the level of franking credits further adds to why it's important to consider dividend growth when considering stocks for income, and not just the level of dividend yield or franking level.

Disclaimer and disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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